

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual

General Tax Audit Manual

20500 PENALTIES

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The California Revenue & Taxation Code provides for the assessment of penalties when taxpayers have not complied with the law. Some penalties are for:

- Failure to file returns/delinquent filing,
- Failure to furnish information,
- Accuracy related,
- Fraud, etc.

There are also provisions to waive penalties under certain circumstances.

Familiarize yourself with the penalty sections of the law and apply them uniformly. When you assess a penalty, you must create a separate issue folder for the penalty. In addition, all notices that assess a penalty must include an explanation.

Reviewed: April 2003

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20505 Supervisor Approval of Penalties

SB 94 requires supervisor approval before you can impose an accuracy related penalty or failure to furnish penalty on all notices issued *after* December 31, 2001.

To comply with the law, the supervisor must review all cases where either penalty is assessed, and provide documentation of that review in the case file.

This provision does *not* apply in the following circumstances:

- Any penalty calculated through electronic means, including Automated Audits
- Any penalty as a result of an Revenue Agent Report

In the absence of the immediate supervisor, another supervisor of equal or higher authority may also approve the penalty.

PROCEDURE:

Your supervisor must review all cases where an Accuracy Penalty or the Failure to Furnish penalty is imposed, except Automated Audit workloads and Revenue Agent Reports.

The supervisor reviewing the case must:

- *Make an entry in the PASS Event log approving the case.*
- or*
- *Sign the Audit Report (FTB 6430) or the Narrative Report*

Because of the language of the law, a "lead" or another auditor who is acting in a review capacity will not meet this requirement.

Reviewed: April 2003

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20510 Failure to File a Return/Delinquent Penalty

CR&TC section 19131 states that if any taxpayer fails to file a return by its due date (including extensions), we add a penalty of 5% of the tax for each month or partial month elapsing thereafter. We determine the due date of the return without regard to any extension of time for filing. The maximum penalty is not more than 25% of the tax. If the failure to file a return is due to fraud, see CR&TC section 19131(d).

If the taxpayer is an individual or fiduciary, and fails to file a return within 60 days without regard to extensions, the penalty is no less than the smaller of:

- One-hundred dollars (\$100), or
- One hundred percent (100%) of the tax required on the return.

We may waive this penalty if the taxpayer can show the failure to file was due to reasonable cause and not willful neglect. Reasonable cause requires the taxpayer to exercise ordinary business care and prudence. If a taxpayer has exercised such ordinary care and prudence and is nevertheless unable to file the return within the prescribed time, then the delay is due to reasonable cause. Forgetting to file or assuming someone else will file is not reasonable cause.

To request a waiver from the *Failure to File a Return/Delinquent Penalty*, the taxpayer must submit a written statement listing facts that support reasonable cause. Generally, you may accept information submitted for reasonable cause in letter format. If you have doubts or need evidence of mailing, you should request an affidavit setting forth the reasons for late filing.

Effective for Notices of Proposed Assessment issued after January 1, 2001, a first time nonfiler will receive a "*Request to File*" letter. If there is no response after 30 days, we issue a Notice that includes tax and late filing penalties. A repeat nonfiler will receive a "*Demand to File*" letter. If there is no response after 30 days, we issue a Notice that includes tax, demand penalty, late filing penalty, and a filing enforcement fee. This applies to Personal Income Tax nonfilers only.

NOTE: A repeat nonfiler is defined as anyone who in the past four years was assessed a nonfiler Notice of Proposed Assessment.

Reviewed: April 2003

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20520 Failure to Provide Information Penalty

When a taxpayer/representative fails, or refuses, to furnish information that you have requested in writing, you should send a formal demand for information. This is appropriate when a response to a request for information is unreasonably delayed, incomplete, or when the request is refused or ignored.

CR&TC section 19133 states that if any taxpayer fails or refuses to furnish any information requested in writing, through a formal legal demand, we may add a penalty of 25 percent of the additional tax.

Before making a formal demand, examine the relevance of the request. Ask yourself:

- Is the request reasonable?
- Have I allowed a reasonable amount of time to gather the requested information?
- Has the information already been provided, but in some alternative format?
- Are other alternatives available?
- Is the failure to provide the requested information due to reasonable cause?

If a demand is necessary, it must refer to:

- The prior requests (initial request, & follow-up to initial request),
- The specific information requested, and
- The need for the specific information. You must also refer to the Failure to Provide Information Penalty under CR&TC section 19133.

You should assess the Failure to Provide Information Penalty when the taxpayer refuses or ignores the formal demand. Apply the penalty uniformly where:

- You have clearly requested the information in writing with an explanation of the need for, and relevance of the information, and
- You have served a formal demand.

We do not accept audit recommendations based upon a lack of taxpayer cooperation, or refusal to furnish information, if you have not documented the

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requests for information in writing. Documentation includes an appropriate initial request, a follow-up to initial request, *and* a formal demand for the information. The demand *must* include a reference to CR&TC section 19133, and state the dollar impact.

Assess penalties unless there is reasonable cause for the failure to provide information. Reasonable cause requires the taxpayer to exercise ordinary business care and prudence. If a taxpayer has exercised such ordinary care and prudence and is nevertheless unable to provide the information, then the failure is due to reasonable cause. Use judgment when determining the applicability of the Failure to Provide Information Penalty, and, if necessary, seek guidance on the matter.

Reviewed: November 2004

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20530 Accuracy Related Penalty

It is our practice to consider the imposition of any penalty in each case where the penalty is applicable. If the accuracy-related penalty is proposed, include a detailed analysis of the taxpayer's failure to meet each of the three defenses in the audit workpapers. Also, discuss each defense with the taxpayer and/or the tax representative.

We may impose the Accuracy-Related Penalty on the portion of any underpayment of tax that should be shown on the return (CR&TC section 19164). The penalty is equal to 20% of the portion of the underpayment caused by one or more of the following:

- Negligence or disregard of rules or regulations;
- Substantial understatement of income tax;
- Substantial valuation misstatement;
- Substantial overstatement of pension liabilities; or
- Substantial estate or gift tax valuation understatement.

NOTE: See CR&TC section 19164.1 for exceptions and special rules for amounts attributable to the Teacher Retention Tax Credit and CA Regulation 19164 for multistate taxpayers.

The statute provides relief provisions or exceptions for each of these situations. We will consider the relief provisions for each situation prior to assessing the penalty. A taxpayer may raise three common defenses (relief provisions) to avoid assessment of the penalty. The defenses are:

- **Substantial Authority** - Substantial Authority exists for the tax treatment of an item on the return [Internal Revenue Code (IRC) section 6662(d)(2)(B)];
- **Adequate Disclosure** - Adequate Disclosure of the transaction has been made on the original return [IRC Section 6662(d)(2)(B)]; and
- **Reasonable Cause** - The taxpayer, in regards to the underpayment, has showed Reasonable Cause and good faith [IRC Section 6664(c)(1)].

Meeting any one of these three defenses will preclude the assessment of the accuracy-related penalty.

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NOTE: The accuracy-related penalty will not apply to any portion of an underpayment on which a fraud penalty applies under IRC section 6663.

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20531 Accuracy Related Penalty - Defenses

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|--------------|---|
| GTAM 20531.1 | Accuracy-Related Penalty - Defense of Substantial Authority |
| GTAM 20531.2 | Accuracy-Related Penalty - Defense of Adequate Disclosure |
| GTAM 20531.3 | Accuracy-Related Penalty - Defense of Reasonable Cause |

Reviewed: April 2003

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20531.1 Defense of Substantial Authority

The defense of Substantial Authority addresses the technical merits of the taxpayer's position. The penalty will not apply if the taxpayer has Substantial Authority for the treatment of the item, regardless of whether the taxpayer meets the defenses of Reasonable Cause or Adequate Disclosure.

In determining whether the taxpayer meets this defense, consider the following:

- Substantial Authority is determined at the time the return is filed or on the last day of the taxable year to which the return relates, not at the time the audit is conducted;
- The "Substantial Authority" standard is less stringent than the "more likely than not" (greater than 50%) standard but is more stringent than the "reasonable basis" standard [Treasury Regulation 1.6662-4(d)(2)].

Example #1 - A return position that is arguable, but fairly unlikely to prevail in court satisfies the reasonable basis standard but not the Substantial Authority standard.

Substantial Authority may exist for more than one position with respect to the same item. Substantial Authority may exist for both the taxpayer's and for FTB's positions, even though the approaches are contrary to each other [Treasury Regulation 1.6662-4(d)(3)(i)].

Example #2 - Based on a Third Circuit Court of Appeals case, a taxpayer's deduction for toxic waste cleanup is not allowable. However, the taxpayer relied on a Fifth Circuit Court of Appeals case from the same year to support the deduction. The facts in these two Circuit Court cases and the taxpayer's case are comparable. For federal purposes, the taxpayer's avenue of appeal is through the Ninth Circuit Court. A basis for Substantial Authority exists for the taxpayer's position.

Example # 2a - The same facts as above, except the Third Circuit Court case is now a Ninth Circuit Court of Appeals case. No basis for Substantial Authority exists for the taxpayer's position.

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20531.2 Defense of Adequate Disclosure

The easiest way for a taxpayer to avoid an accuracy-related penalty, based on a substantial understatement of tax, is to adequately disclose all the relevant facts affecting an item's tax treatment on the tax return. If the item is adequately disclosed, then the penalty will not apply, regardless of whether the taxpayer meets the defenses of Reasonable Cause or Substantial Authority.

NOTE: Adequate Disclosure includes the element of reasonable basis [IRC section 6662(d)(2)(B)]. Do not confuse reasonable basis with Reasonable Cause, the third defense against the accuracy-related penalty [IRC section 6664(c)(1)].

How To Properly Disclose Information About An Item

Disclosure of an item is adequate if it is made on a properly completed statement attached to the original California return or a qualified amended return.

- The taxpayer files Internal Revenue Service (IRS) Regulation Disclosure Statement; Form 8275-R, when taking a position contrary to a regulation.
- The taxpayer files IRS Disclosure Statement Form 8275, for items or positions other than those that are contrary to a regulation.

NOTE: Properly completed forms and attachments are required for certain items (such as charitable contributions, employee business expenses, and interest expense). The required forms and attachments are updated annually by the IRS through Revenue Procedures. The Revenue Procedures apply for California purposes in the absence of specific state procedures.

The following rules apply when making a disclosure to avoid the accuracy-related penalty due to a substantial understatement of tax:

- Disclosure regarding recurring items must be made each year;
- Disclosure with respect to a carryover item is only necessary for the taxable year in which the carryover arises. Disclosure is not required during the year that the carryover is utilized; and
- Disclosure of how income is apportioned or allocated to California (for example, the identification of the combined group and treatment of intercompany transactions) can be made by attaching a statement to the return.

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Using a Qualified Amended Return to Disclose Information

If a taxpayer does not adequately disclose an item or position on their original return, they may still qualify for the exception to the accuracy-related penalty if the disclosure is made on a qualified California amended return. A California qualified amended return is generally defined as an amended return filed after the due date of the return and before the time the taxpayer is first contacted by the Franchise Tax Board concerning an examination of the return. A California qualified amended return:

- Must be filed on a California Amended Return Form (Form 100X for corporations and Form 540X for individuals); and
- Must include a completed IRS Form 8275 or 8275-R disclosing the relevant facts or position taken by the taxpayer.

Statements to disclose relevant facts regarding the apportionment or allocation of income to California are acceptable.

NOTE: To ensure proper handling, the taxpayer should write "SUBSTANTIAL UNDER-STATEMENT DISCLOSURE" on the top of the first page of the amended return.

If a qualified amended return with Adequate Disclosure is not made prior to the time the Franchise Tax Board contacts the taxpayer regarding an examination, the automatic waiver is not available and the taxpayer must show Reasonable Cause or Substantial Authority to avoid the penalty.

Special rules, for filing qualified amended returns, apply to taxpayers who are subject to the IRS Coordinated Examination Program. See FTB Notice 92-9 (Substantial Understatement Penalty Guidelines).

Adequate Disclosure Will Not Solve All Problems

Properly disclosing an item will generally insulate a taxpayer from the penalty based on:

- Substantial understatement of tax; or
- Negligence / disregard of the rules and regulations.

However, even if the taxpayer discloses an item, there is no automatic waiver of the penalty in the following circumstances:

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- If the position taken on the return is frivolous. Frivolous is defined as "patently improper". A reasonable basis must exist for the taxpayer's tax treatment to avoid the penalty;
- If the penalty is based on negligence or disregard of the rules and regulations, the Adequate Disclosure defense is not available. In order to have a reasonable basis for the position, the taxpayer cannot be negligent or disregard the rules and regulations;
- If the taxpayer fails to keep adequate records or fails to properly substantiate the item;
- If the item is attributable to a tax shelter; or
- If the penalty is due to negligence or disregard of the rules and regulations, the taxpayer may not rely upon the Revenue Procedures to define what constitutes Adequate Disclosure.

NOTE: "Adequate Disclosure" is defined differently for the accuracy-related penalty than for purposes of the 6-year statute of limitations provided for in CR&TC section 19058.

Reviewed: April 2003

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20531.3 Defense of Reasonable Cause

The defense of Reasonable Cause addresses the taxpayer's reasons for the tax treatment of an item. The penalty will not apply if the taxpayer has Reasonable Cause and has acted in good faith in determining the treatment of an item, regardless of whether the taxpayer meets the defenses of Substantial Authority or Adequate Disclosure.

NOTE: Adequate Disclosure includes the element of reasonable basis [IRC Section 6662(d)(2)(B)]. Do not confuse reasonable basis with Reasonable Cause, the third defense against the accuracy-related penalty [IRC Section 6664(c)(1)].

The determination of whether a taxpayer acted with Reasonable Cause and in good faith is made on a case-by-case basis. Generally, the most important factor is the extent of the taxpayer's effort to assess the proper tax liability. Circumstances that may indicate Reasonable Cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer.

Examples of how this defense applies are found in Treasury Regulation section 1.6664-4.

a. Reasonable Cause - Reliance on a Representative

The most common defense under Reasonable Cause is "Reliance on a Representative" (outside tax advisor/return preparer). When reviewing the defense of Reasonable Cause - Reliance on a Representative, it is not necessary to show Substantial Authority for, or Adequate Disclosure of, the position taken. Reasonable Cause is a stand-alone defense. The taxpayer need only show that their reliance on the representative was reasonable based on their knowledge, and that they acted in good faith.

NOTE: A taxpayer that does not hire an outside representative to interpret an issue of substantive law, but instead relies on an internal tax department to determine the tax position taken on the return can still raise the defense of Reasonable Cause. In this situation, the taxpayer's defense is "Reasonable Cause" rather than "Reasonable Cause - Reliance on a Representative". The primary defense raised when the taxpayer relies on an internal tax department is

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often Substantial Authority and/or Adequate Disclosure. Reasonable Cause could still be a defense. The requirements and procedures further discussed are also relevant in the situation where you are reviewing the defense of Reasonable Cause where the taxpayer has not relied on the advice of a representative, but has instead relied on the advice of an internal tax department. *Burruss Land and Lumber Company vs. US*, 72-2 USTC 16,056.

Apply the following interpretive statements on current and future audit cases:

Position Statement: Taxpayers relying on a representative with a relevant tax background to address substantive tax issues may raise a defense of Reasonable Cause. Reasonable Cause is interpreted to mean the exercise of ordinary business care and prudence. *United States v. Boyle*, 469 US 241 (1985). Reasonable Cause - Reliance on a Representative is not an automatic defense and substantiation of the defense is required. Automatic exceptions that preclude raising the defense of Reasonable Cause include the following:

- The taxpayer withholds critical information from the representative which is relevant to the correct determination of the issue;
- The representative, that the taxpayer relied on, was not qualified in the area of tax law;
- A blatant error occurs that the taxpayer should have found; or
- The taxpayer has sufficient knowledge to determine that a position taken on the tax return is incorrect, and thus, it was not reasonable for the taxpayer to rely on the advice.

The fact that a representative took a questionable position does not automatically preclude the defense of Reasonable Cause. The key question is whether the taxpayer, given their knowledge, had reason to question the advice. If so, that raises doubt as to whether they could reasonably rely on the advice. This theory is widely upheld by federal tax case decisions dealing with the accuracy related penalty where a key factor in upholding or withdrawing the penalty rested on the sophistication of the taxpayer regarding tax matters, and whether or not this level of sophistication would have caused the taxpayer to realize a mistake had been made upon review of the return. *Vorsheck v. CIR*, 933 F2d 757 (9th Cir., 1991); *Viani v. Commissioner*, 68 TCM 776 (1994); *Mauerman v. CIR* 22 F3d 1001 (10th Cir., 1994); and *Caughlin v. Commissioner*, 67 TCM 2429 (1994)

With the increasing complexity of the tax law, many taxpayers are hiring representatives to advise them on certain tax matters, or to prepare their return. No requirement exists that taxpayers must obtain a detailed understanding of the

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tax laws as they relate to substantive issues. Nor does a requirement exist which would require the taxpayer to research a position taken by the representative. This theory is upheld in the Supreme Court decision of ***United States v. Boyle***, 469 US 241. The Supreme Court specifically states that requiring the taxpayer to challenge the substantive advice of a competent accountant or attorney, or seeking a "second opinion", or monitoring the representative on the tax law would nullify the very purpose of seeking the advice of a presumed expert in the first place. The court held that seeking professional help is the act of a "reasonable person" exercising "ordinary business care and prudence". Based on judicial and regulatory authority, an important factor relevant to the determination of Reasonable Cause is the extent of the taxpayer's efforts to assess the proper tax liability. Hiring a representative to address a substantive issue of tax law is viewed as a reasonable effort to determine the proper tax liability if the taxpayer does not have knowledge to determine the proper tax liability. When the taxpayer selects a competent tax advisor and supplies the advisor with all relevant information, it is consistent with ordinary business care and prudence to rely upon the advisor's professional judgment in determining the taxpayer's tax obligations.

Penalties are applied to encourage voluntary compliance, not to punish conduct that is reasonable. Consider all facts and circumstances of the taxpayer, as well as past compliance history.

In order to qualify for the Reasonable Cause - Reliance on a Representative defense, the taxpayer must demonstrate the following:

- The taxpayer provided necessary and accurate information;
- The tax advisor or return preparer had sufficient expertise to justify reliance; and
- The taxpayer actually relied in good faith on the tax advisor or return preparer's judgment.

Below is a listing of general procedures to follow and questions to ask when determining the applicability of the accuracy-related penalty based on the defense of Reasonable Cause - Reliance on a Representative. The following list of questions and procedures is not all-inclusive. The facts and circumstances of each case will control the procedures to follow and the questions to ask.

The taxpayer must provide full disclosure of all facts and circumstances to the representative. The representative's opinion must be based on all pertinent facts and circumstances of the situation. Failure of the taxpayer to disclose a fact

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or circumstance that is known and relevant, or that should be known, to determine the proper tax treatment of the item precludes the defense of Reasonable Cause - Reliance on a Representative. The submission by the taxpayer of internally prepared financial statements or summaries with supporting documentation may not necessarily be full disclosure.

Methods of determining whether or not full disclosure occurred are based on the facts and circumstances of each case. Because the auditor did not see the transfer of information does not establish a prima facie case that the information was not provided. Review the following to determine the information and documentation provided to, and requested by, the representative:

- Document requests from the representative to the taxpayer;
- References to documents obtained in the tax representative's file or referenced in the opinion letter; and
- Affidavits from the taxpayer and the representative signed under penalty of perjury identifying what information was given and received.

For tax returns due on or after September 2, 1995 (determined without regard to extensions), regulatory authority provides that the advice:

- Must take into account the taxpayer's purpose for entering into a transaction and for structuring the transaction in a particular manner (Treasury Regulation section 1.6664-4(C), as amended by TD 8617, August 31, 1995); and
- Must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person (Treasury Regulation section 1.6664, as amended by TD 8617, August 31, 1995). In essence, a representative should verify both the tax aspects and the significant non-tax business aspects of a transaction to meet this regulatory provision.

Non-tax aspects of a transaction may or may not be material to the determination of the correct tax treatment. For all cases, the facts and circumstances will determine whether or not the auditor advances the argument that knowledge of the non-tax aspects of a transaction were material and critical to the determination of the correct opinion and that the representative, and/or taxpayer, had insufficient knowledge of these non-tax aspects.

If the non-tax aspects are material and relevant, the auditor should perform a review of the representative's reliance on the information provided by the

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taxpayer. Verify that the representative did not base his recommendation on any assumptions. Did the representative ask for additional information or clarification from the taxpayer or any other person? For example, verifying a non-tax aspect might include a situation where the taxpayer provides the representative with an appraisal showing the valuation of an asset contributed to charity (a non-tax aspect of the transaction). The representative should verify the qualifications of the appraiser if the representative is not a qualified appraiser himself.

Advisor must be competent in the area of income taxation law. The advisor must be competent in the area of income tax law. Competency in a specific area of income tax law, such as S corporation law if the issue deals with an S corporation, is desirable but not required.

Taxpayers are not required to utilize a California representative. An out of state representative implies to the client that he will obtain competency in the subject matter at issue if he is not already competent, upon accepting the engagement. Enrolled Agents, Certified Public Accountants, and lawyers are held to this professional standard of conduct.

The advisor must be independent of the consequences of the transaction on which advice is provided. For example, judicial authority has addressed cases where the tax advisor is advising a client to invest in a certain corporation's stock. In addition to acting in the capacity as a tax adviser, the representative is vice president and majority shareholder of the corporation. Advice given on the investment, for purposes of making the investment and the tax consequences thereon, was not considered independent so that the taxpayer could rely on them, as the advisor benefited from the transaction if the taxpayer invested. **Mauerman v. CIR** 22 F3d 1001 (10th Cir., 1994); **Fisher v. Commissioner**, 64 TCM 1670 (1992)

Review the records to verify the independence of the advisor. You should ensure the advisor did not realize an economic benefit from the transaction that could impair his independence (for example, misrepresenting the financial condition of a corporation to sell shares of stock when the advisor receives a percentage of the sales proceeds from the stock.)

The representative must give advice to taxpayers on which they rely. Generally, the defense of Reasonable Cause - Reliance on a Representative will cover advice related to a matter of law, but could extend to issues dealing with matters of computation, procedures, remedial law, or administrative law.

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Advice does not have to be in written format, but it must include any communication that sets forth the analysis or conclusion recommended by the professional tax advisor, and provided to the taxpayer. In the case of a large corporate taxpayer, communications are generally in writing. A written analysis is probably available for significant issues/transactions.

A representative's preparation of a return based solely on internally prepared financial statements provided by a taxpayer (in the absence of supporting documentation) generally does not constitute the giving of advice. Discussions or calculations regarding either the treatment of an item on the return or a discussion as to whether or not a return is due must occur.

The taxpayer must reasonably rely on the advice given. Verify that the advice given by the representative was used to determine the tax liability reported. Determine the level of tax knowledge of the taxpayer. Determine if based on this knowledge, reliance on the position taken by the representative is reasonable. Some items to consider when determining the taxpayer's knowledge:

- Education level of the taxpayer and field of experience. Example: A doctor, though well educated may not have relevant knowledge of tax law;
- Experience in business and investment transactions. Some cases hold that a taxpayer who holds any interest in partnerships and/or corporations, or has portfolio investments, is held to a higher degree of sophistication and knowledge for purposes of determining if reliance is reasonable; other judicial authority has held these factors are irrelevant, **Vorsheek v. CIR**, 933 F2d 757 (9th Cir., 1991); **Heasley v. Commissioner**, 55 TCM 1748 (1988); **Pace v. Commissioner**, 70 TCM 1506 (1995). Consider these factors, as well as experience necessary to perform job duties. However, the education level and tax knowledge of the taxpayer prevails. The taxpayer's knowledge to invest in a profitable venture and to invest in more than one activity does not necessarily indicate knowledge of tax law. Also, the fact that the taxpayer is the CEO of a manufacturing company does not necessarily indicate knowledge of tax law;
- Frequency of the issue. An issue that occurs annually and is reported one way, and then suddenly reported differently should cause the taxpayer to question the new treatment;
- Extent and sophistication of an internal tax department. If the taxpayer is a corporation, give consideration to whether or not the corporation has an

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internal tax department, and if so, the sophistication of the tax personnel. The knowledge of personnel employed in a corporate tax department is imputed to the corporate taxpayer. Advice received from an internal tax department does not constitute advice from a representative for purposes of determining if Reasonable Cause - Reliance on a Representative has occurred (Treasury Regulation section 1.6664-4(c)(2)). The defense of Reasonable Cause - Reliance on a Representative applies to advice given by someone other than the taxpayer. If the corporation seeks advice from an independent advisor, consideration of the knowledge of the internal tax department, to determine if it was reasonable or not for the taxpayer to rely on the advice based on the taxpayer's knowledge, is appropriate.

NOTE: It is presumed the corporation's internal tax department personnel reviews and concurs with all such advice sought from an independent advisor prior to the final presentation of the position on the tax return. Some of the items to consider with corporate taxpayer's are

- Does the corporation have a tax department?
- How large is the tax department and what is the background of its members?
- Are there state and local tax personnel present? If so, are any of them well versed in California franchise/income tax laws?
- What is the background of those who provided the advice on the position taken?
- Was an independent third party analysis sought?
- Did the internal tax department review any independent third party advice? If so, request documentation to support the internal tax personnel's findings.
- Was any other advice given by the representative that contradicts the position taken on the return?
- Verify if the taxpayer was informed of the likelihood the position would prevail if examined. If the taxpayer was told that the position has a 10 percent chance of being sustained, reasonable reliance on the representative's opinion would probably not be found;

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- Determine if the taxpayer is using a new representative due to an unagreed opinion received from a prior representative. If this is the first year the taxpayer has utilized the current representative while taking the contested position, attempt to ascertain whether or not the prior representative advised the taxpayer on the contested issue. If so, did the prior representative issue a different conclusion, which resulted in the switching of representatives? If the prior representative advised the taxpayer that the position was not appropriate, a basis exists which could preclude the taxpayer from raising the defense of Reasonable Cause. The taxpayer should have known it was probably not reasonable to rely on the advice of the second representative. This position is determined based on the facts and circumstances of each case. Review the taxpayer's records to determine if this situation exists. Some items to consider are:
 - Accounting fees paid. Check to see if accounting fees were paid to more than one representative.
 - Supporting documents. Ascertain why there was more than one representative. Review any supporting documents and correspondence made with each of the representatives. **NOTE:** Do not contact the prior representative without the written consent of the taxpayer. The attorney/client privilege may be invoked in regards to this information. This is not indicative that the prior representative advised the client in a manner different than the position taken on the return.
 - Determine if the representative issued any advice on the non-tax aspects of a transaction. An opinion issued by the representative regarding the non-tax aspects of a transaction, (e.g., a CPA valuing property for purposes of computing a gain or loss) would not allow the taxpayer to raise the defense of Reasonable Cause - Reliance on a Representative, if the representative is not qualified in the area of the non-tax aspect item (in this example the CPA must be a qualified appraiser as well as a tax professional).

The contested position taken on the return, or an error, cannot be blatantly incorrect.

Reasonable Cause requires a taxpayer to demonstrate that his actions are those of an ordinary and prudent businessperson. Determine, based on the knowledge

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of the taxpayer acting as an ordinary and prudent businessperson, if they should have discovered the error.

An ordinary business person is presumed to review his return. If he knows he earned \$100,000 in wages but only \$10,000 in wages is reported, a review of the return would identify this error. *Caughlin v. Commissioner*, 67 TCM 2429 (1994)

Keep in mind that the Supreme Court has stated, "Whether the elements that constitute 'reasonable cause' are present in a given situation is a question of fact, but what elements must be present to constitute 'reasonable cause' is a question of law."

***U.S. v. Boyle*, 469 U.S. 241 (1985).** Each case must be reviewed to establish its own set of facts and circumstances. If based upon those facts and circumstances, the taxpayer shows that there was Reasonable Cause for the position taken and that the taxpayer acted in good faith with respect to that position, a penalty should not be assessed. This conclusion is in accord with the principle declared by the Supreme Court that the penalties under the revenue laws are designed to impose upon conduct "which is intentional, or knowing, or voluntary, as distinguished from accidental."

***U.S. v. Murdock*, 290 U.S. 389.** "It is not the purpose of the law to penalize.... innocent errors made despite the exercise of reasonable care." *Spies v. U.S.* 317 U.S. 492 (1943)

b. Reasonable Cause - Reliance on a K-1

If a taxpayer (investor) has an underpayment attributable to a pass-through item, consider the actions of the Pass-Through Entity (PTE) and the taxpayer/owner when making the determination of whether the taxpayer meets an exception to the accuracy-related penalty under CR&TC section 19164 (incorporating IRC sections 6662, 6663 and 6664).

In general, the auditor must take the following steps before assessing the accuracy-related penalty.

- The auditor must consider the actions of both the PTE and the taxpayer/owner to determine if an exception to the application of the penalty is met.

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- **Reasonable Cause:** The auditor should generally impute the Reasonable Cause and good faith of the PTE to the taxpayer/owner with the underpayment. However, even if the actions of the PTE satisfy the Reasonable Cause exception, factors may indicate that the taxpayer did not act with Reasonable Cause and good faith. If so, the penalty may still apply to the taxpayer/owner's underpayment.

Example - If the taxpayer reported items inconsistent with the K-1 without cause, or failed to report K-1 items altogether, the FTB can challenge the Reasonable Cause and good faith imputed from the PTE to the taxpayer.

- **Adequate Disclosure:** In order for this exception to apply, the auditor should look for the required disclosure (IRS Form 8275 or 8275-R, as appropriate) either on the return of the PTE or the taxpayer/owner.
- **Substantial Authority:** There are no special rules for applying the Substantial Authority exception for underpayments due to items attributable to PTEs unless the entity is a tax shelter or the item is a tax shelter item. Therefore, the general rules and definitions apply. See the discussion below for special rules for tax shelters.

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- The auditor must independently determine the applicability of the penalty given the facts and legal authority present in the case. If the auditor can determine that the penalty is not applicable based on the facts and circumstances of the case, then it is not necessary to bring the issue to the taxpayer/owner's attention. The penalty will not automatically apply just because the potential penalty amount exceeds the various threshold tests. If the auditor remains unsure whether the penalty would apply, then the auditor must develop all sides of the issue and appropriately weigh conflicting authorities as a basis for the penalty. The auditor may need to discuss the issue with the taxpayer in order to factually develop the issue.
- If the auditor determines the penalty may apply after weighing the facts/legal authority, then the auditor must discuss the potential applicability of the penalty with the taxpayer/representative before completing the examination. The auditor must also explain the exceptions to the penalty that the taxpayer may meet.
- The auditor must give the taxpayers the opportunity to demonstrate they meet one of the exceptions before closing the case.
- The audit file must document and support the basis for assessing the penalty.

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20532 Accuracy Related Penalty – Checklist

Taxpayer Name:

Identification Number:

Case Unit Number:

Audit Years:

	NO	YES
STATUTORY REASONS FOR ASSESSMENT		
(meeting any one will trigger the penalty)		
Substantial Understatement of tax		
Negligence or disregard for rules or regulations		
Overvaluation penalties		
Fraud		

DEFENSES TO APPLICABILITY

(meeting only one defense is necessary to avoid the penalty*)

Substantial Authority		
Adequate Disclosure		
Reasonable Cause		

*If no is checked for all three defenses, the penalty should be proposed for assessment and the penalty must be fully analyzed in workpapers and discussed with the taxpayer.

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20540 Fraud Penalty

CR&TC section 19164 provides for the imposition of a fraud penalty. This penalty is determined in accordance with Internal Revenue Code section 6663.

IRC section 6663 provides for the imposition of a fraud penalty if any part of any underpayment of tax is due to fraud. The penalty is equal to 75 percent of the portion of the underpayment that is attributable to fraud.

The courts have defined fraud as the intentional wrongdoing on the part of the taxpayer with the specific intent to avoid a tax known to be owing (*O.C. Akland*, CA-9, 85-2 USTC ¶9593). Negligence or ignorance of the law does not constitute fraud.

We may impose the fraud penalty where the taxpayer:

1. Knew the contents of the return when he or she signed it,
2. Knew the return to be false, and
3. Made the return with the fraudulent intent to evade tax.

You should examine the taxpayer's entire course of conduct to establish intent. The FTB has the burden of proof when applying the fraud penalty.

The FTB must prove fraud by clear and convincing evidence, but we can infer intent from strong circumstantial evidence. Because fraudulent intent is rarely established by direct evidence, the courts have inferred intent from various kinds of circumstantial evidence. These "*indications*" of fraud include:

1. Understatement of income.
2. Inadequate records.
3. Failure to file tax returns.
4. Implausible or inconsistent explanations of behavior.
5. Concealing assets.
6. Failure to cooperate with tax authorities.

Unlike criminal fraud, civil fraud need not be proved beyond a reasonable doubt.

Ordinarily a taxpayer is not liable for fraud penalties if the taxpayer acts on the advice of counsel. However, the taxpayer must show that complete and accurate

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information was provided to the attorney. A taxpayer cannot escape the penalty by delegating preparation of the return to someone else.

If the penalty is assessed, the audit file must contain a workpaper section discussing the facts upon which the penalty is based. Include the taxpayer's statement as to why they feel that the penalty does not apply (if applicable), and why the penalty should apply.

NOTE: For assessments based upon Revenue Agent Reports, if the IRS has assessed the fraud penalty, we will not automatically assess the penalty. This is because the presumption of correctness is not present. The FTB must independently prove fraud in order to assess the penalty.

Reviewed: April 2003

20540 TAX SHELTER PENALTIES

Please see the following for information on penalties that may be assessed for Abusive Tax Shelter Transactions.

[Franchise Tax Board - Abusive Tax Shelters & Transactions, Penalties](#)

All GTA tax shelter cases that include tax shelter penalties must also include an alternative/secondary penalty position. Workpapers must be completed and the secondary position discussed with the taxpayer/rep. In addition, the NPA must include the imposition of the secondary penalty in the event the primary tax shelter penalty(ies) is not upheld on appeal.

Reviewed: November 2004

20560 TAX SHELTER PENALTIES – RARs

The following are general guidelines for assessing the California penalties on RARs. There may be exceptions to these guidelines on a case by case basis. You may need to consult your supervisor and/or audit manual for exceptions.

Generally, follow the penalties as assessed by the IRS on the RARs and consider the following penalties when applicable:

1. **Interest Based Penalty:** The 100% Interest Based Penalty (IBP) may be pursued. The determination may be based on audit work papers obtained

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from the IRS. * * * * *

Non-economic Substance Transaction understatement penalty: The Non-economic Substance Transaction Understatement Penalty (NEST) may be pursued. The determination may be based on audit work papers obtained from the IRS. * * * * *

* * * * *

However, where the federal accuracy related penalties (ARP) are assessed based on the RAR, follow the ARP on the RAR since the IRS has already developed the audit case for the ARP. Note: NEST and ARP cannot be assessed at the same time; only one or the other could be assessed.

2. **Accuracy Related Penalty:** The RAR program may apply the accuracy related penalty based on the RAR following normal procedures. If the ARP is not assessed by the IRS on the RAR, consider assessing the NEST as noted in item 2 above. If the transaction does not meet the NEST requirement, do not pursue the accuracy related penalty. The reason behind not assessing the accuracy related penalty is that the penalty needs to be developed.
3. **Fraud Penalty:** The RAR program may consider the Fraud penalty based on the RAR. The determination may be based on the audit work papers obtained from the IRS. * * * * *
4. **Reportable Transaction Understatement Penalty:** This penalty applies to tax year beginning on or after January 1, 2003. This penalty may not be pursued because of the complexity.

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20600 INTEREST

GTAM 20610	Interest Assessed
GTAM 20620	Interest Abatement
GTAM 20630	Interest Paid
GTAM 20640	Interest Rates
GTAM 20650	ADINT (Interest Calculation)
GTAM 20660	Additional 2% Interest (CR&TC section 19521(c))
GTAM 20670	Avon Interest Adjustment

Reviewed: April 2003

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20610 Interest Assessed

Taxes are due and payable as of the original due date of the taxpayer's return (without regard to extension). If the tax reported on the taxpayer's return is not paid by the original due date, or if the Franchise Tax Board assesses additional tax, interest must be computed and charged on the balance due, including penalties, if any (CR&TC section 19101). Interest is compounded daily (CR&TC section 19521) and begins accruing from the date payment is due (CR&TC section 19104).

Interest is assessed, collected, and paid in the same manner as the tax. Compute interest from the date payment of tax is due (usually coincides with the original due date of the tax return) until the date the deficiency is paid. If the tax is paid in installments, interest accrues on the unpaid portions of the liability until the entire balance due is paid (CR&TC section 19104(a); also *Appeal of Richard E. and Geraldine Goodman, Cal. St. Bd. of Equal., October 10, 1984*).

Erroneous refund interest is charged from 30 days after the taxpayer is notified of the erroneous refund to the date the money is repaid. If the refund check is returned, no interest accrues (CR&TC section 19104(b)).

Interest may be suspended for PIT taxpayers for some tax years. See GTAM 9510.

Reviewed: November 2004

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20620 Interest Abatement

The imposition of interest upon a deficiency is mandatory (*Appeal of Amy M. Yamachi, Cal. St. Bd. Of Equal., June 28, 1977*). The requirement that mandatory interest be charged to the date of payment is not overcome by a delay in the determination of a proposed assessment or in the subsequent administrative review process (*Appeal of Patrick J. and Brenda L. Harrington, Cal. St. Bd. of Equal., January 11, 1978*).

Interest is not a penalty imposed on the taxpayer. It is simply compensation for the use of money (*Appeal of Audrey C. Jaegle, Cal. St. Bd. of Equal., June 22, 1976*). However, under CR&TC section 19104, the FTB may abate all or part of the interest if certain conditions are met. California also follows Treasury Regulation 301.6404-2T in administering interest abatement provisions.

In 1997, the passage of AB 713 conformed California to the federal Taxpayers' Bill of Rights 2. Provisions for abating interest are different depending on whether the tax year involved begins on or after January 1, 1998. Specifically, three aspects were added:

1. For tax years beginning on or after January 1, 1998, FTB is allowed to abate interest that is attributable to "unreasonable" error or delay in FTB's performance of a ministerial or "managerial" act.
2. AB 713 added the terms unreasonable and managerial to California Revenue and Taxation Code section 19104. Refer to FTB Notice 98-5 and Treas. Reg. Section 301.6404-2T for definitions.
3. For abatement requests made on or after January 1, 1998, the taxpayer is allowed to appeal to the State Board of Equalization the FTB's determination to deny abatement. The appeal must be within 180 days of the FTB's determination (California Revenue and Taxation Code section 19104(c)(1)(C)(ii)). Under prior law (which applied to requests made before January 1, 1998), FTB determinations were final and not allowed to be heard by the Board of Equalization.

In 2000, the passage of AB 463 (Ch. 99-183) revised CR&TC section 19104 and changed the circumstances under which we may abate interest. In certain cases, the law now requires taxpayers to raise the interest abatement issue at the time of the appeal of the deficiency or be limited thereafter from raising the issue.

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CR&TC section 19104 now provides specified limitations on the time for taxpayers to appeal and specifies the circumstances under which the Franchise Tax Board will deny a request to abate interest. The revisions apply to requests for abatement of interest filed on or after January 1, 2001.

Other significant points of the law change include the following:

- It clarifies that the *interest* on the deficiency, not the deficiency itself, is subject to abatement.
- It allows taxpayers who protest a deficiency to include a request of certain related interest in their protest.
- In circumstances where taxpayers have not included the request for abatement of interest during the original protest but later file an appeal of the proposed deficiency, taxpayers may include a request for the abatement of interest with their appeal of the underlying proposed deficiency.
- It precludes taxpayers from making a separate request at a later time, if taxpayers have protested or appealed the underlying deficiency and have not made a request for abatement of interest during the protest or appeal.
- If a taxpayer does not protest or appeal the Franchise Tax Board's adverse action on an underlying proposed deficiency and is only appealing an adverse action on a request to abate interest, or is requesting an abatement of interest that has accrued between the time the deficiency was final and the time the Notice of Tax Due is issued, the taxpayer may make a request for the abatement of interest on Form FTB 3701, *Request for Abatement of Interest*.
- If a taxpayer is denied a request for abatement through the Franchise Tax Board issuing a *Notice of Action* or a *Notice of Determination*, taxpayer may appeal to the State Board of Equalization within 30 days of the date on the notice (for unpaid interest), or within 90 days (for paid interest).
NOTE: This differs from the previous time period to file an appeal on the denial of interest abatement, which was 180 days.
- If the Franchise Tax Board does not respond to a taxpayer's request for abatement of certain interest within six months (not including requests made at protest or appeal), the taxpayer may treat the request as if it is denied and file an appeal with the State Board of Equalization within the above referenced timeframes.

As stated in FTB Notice 98-5, the FTB has developed Form FTB 3701, *Request for Abatement of Interest*, for taxpayers to use to request waiver of interest for periods attributable in whole or in part to error or delay by one of our officers or

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employees in performing a ministerial or managerial act. They can download the form from our Internet website or request it by telephone at (800) 852-5711. They should mail the completed Form 3701 to:

Franchise Tax Board
Taxpayer Advocate Bureau, Mailstop B-20
Interest Abatement Coordinator
P.O. Box 157
Rancho Cordova, CA 95741-0157

Reviewed: April 2003

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20630 Interest Paid

Interest is paid on overpayments resulting from an audit. It is compounded daily and computed from the date of overpayment to the date paid, taking into account a 30-day grace period for processing (California Revenue & Taxation Code section 19340). In other words, interest will be paid for the computed period except for 30 days to allow for processing.

In the case of a refund from an originally filed return, interest will accrue if the refund is not paid within 90 days of the filed date.

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20640 Interest Rates

The rate of interest is provided by statute and is adjusted periodically by the Legislature. We cannot impose interest at any other rate than the "*adjusted annual rate*." Interest, at the rate specified by law, is compounded and accrues on the balance due until the date the liability is completely paid. This means that interest accrues not only on the tax and applicable penalties, but also on the interest balance due (CR&TC section 19521; Internal Revenue Code section 6621).

We compute the interest rate semi-annually. Interest accruing after June 30, 1983 is compounded daily on:

- Unpaid tax,
- Interest, and
- Certain penalties.

We compute interest on tax from the original return due date to the date the tax is paid. We compute the interest on delinquent, underpayment, and accuracy-related penalties from the return due date, including extensions. We compute all other penalties from the notification date (the transaction date on the video) to the date paid.

If the taxpayer pays the entire assessment within 15 days of the original notification, we charge no interest.

Note: Suspension of interest may apply to some PIT taxpayers. For details, see GTAM 9510.

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20650 ADINT (Interest Calculation)

You can use the ADINT program to compute interest automatically on a debit or credit balance. You can also compute the estimate penalty using ADINT.

If you use the ADINT program to give estimates of interest due, you must notify the taxpayer that it is an *estimate only*.

Interest Computations for Corporations

Request an interest computation from Audit Business Support when:

- An Avon Interest Adjustment is necessary (see GTAM 20670, *Avon Interest Adjustment*), OR
- You need an exact figure.

The fastest way to get a corporate interest computation is to forward an interest calculation request form. Access the form at:

<http://ftbnet/businessentities/RequestForms/InterestComputationRequest/BES%20AS%20INTEREST%20COMPUTATION%20REQUEST%20FORM.doc>

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20660 Additional 2% Interest (CR&TC section 19521(c))

An additional 2% interest rate is applicable for taxable years beginning January 1, 1992, and only for C corporations owing us balances. It will be due on any unpaid amount for that taxable year if the cumulative unpaid tax exceeds \$100,000. Once the corporation meets the cumulative threshold amount of \$100,000 in unpaid tax, all underpayments for that year are subject to the additional 2% interest from the later of January 1, 1992, or the earliest applicable date occurring for that year.

The "*threshold amount*" includes regular tax, Notices of Proposed Assessment and alternative minimum tax, but not penalties and interest.

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20670 Avon Interest Adjustment

California and federal laws are essentially the same in the area of interest assessment. Therefore, the state follows the federal interpretation for the application of the Avon decision (*Avon Products, Inc. v. United States*, 588 F. 342).

The Avon decision is based on the “*use of money*” principle. This principle states that for any period during which the government has use of the taxpayer’s money, interest on a subsequent assessment should not be charged if during the same period the government had use of an overpayment.

When a taxpayer’s original return reflects an overpayment that was credited to another year or refunded without interest, and there is a subsequent assessment, interest is charged only when the tax (to the extent of the overpayment) is considered due and unpaid. The tax is transferred to another year or refunded to the taxpayer (refer to Revenue Ruling 88-98).

The Avon decision applies to timely and delinquent filed returns. It does not apply to overpayments transferred as the next year’s first estimated tax payment.

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20700 FEDERAL AUDITS

To determine if a federal audit is in progress, you should contact the Federal and State Special Audit Section. If during the course of an examination, you determine that federal activity is occurring, or has occurred, you should observe the following procedures:

Revenue Agent Reports (from IRS) on Years under Examination

- **Federal Audit in Progress** - If there are no state issues for audit, forward the case to the RAR Unit in Central Office (see the mailstops listed below). Secure a copy of the IRS request for information, and a federal waiver if applicable. Otherwise, continue the examination of the state only audit issues.
- **Federal Audit Complete**
 1. If you receive a federal “*No-Change*” letter and there are no state issues, attach the letter to the back of the return to which it applies and treat as a survey case. Otherwise, continue the examination of the state only audit issues.
 2. If federal adjustments are made and there are no state issues, get a copy of the RAR and forward it to the RAR Unit in Central Office (see the mailstops listed below).
 3. If you are going to work the RAR with the state adjustments, you must notify the RAR Unit at the time you receive the RAR. This is especially important when you may not complete the audit for the state issues for some time. By coordinating with the RAR Unit, the case can be put on the RAR PIT or Corporation Local Area Network with comments. When the RAR comes in through normal channels, the RAR Unit will not issue a Notice of Proposed Assessment inadvertently. If the RAR Unit receives an RAR and finds that the case is assigned to an auditor, the staff in the RAR Unit will contact you before taking any action. **NOTE:** If federal adjustments are based upon the lack of substantiation, give the taxpayer an opportunity to submit substantiation before closing the examination.
- **Federal Audit Protest** - If an RAR is being protested or appealed, get a copy of the RAR and forward it to the RAR Unit in Central Office (see the

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mailstops listed below). **NOTE:** If the state does not conform to the federal statute, or has a different statute, you may make a state adjustment without regard to the federal decision.

1. If federal adjustments are made and there are no state issues, get a copy of the RAR and forward it to the RAR Unit in Central Office (see the mailstops listed below).
2. If you are going to work the RAR with the state adjustments, you must notify the RAR Unit at the time you receive the RAR. This is especially important when you may not complete the audit for the state issues for some time. By coordinating with the RAR Unit, you can put the case on the RAR PIT or Corporation Local Area Network with comments. When the RAR comes in through normal channels, the RAR Unit will not issue an NPA inadvertently. If the RAR Unit receives an RAR and finds that the case is assigned to you, the staff in the RAR Unit will contact you before taking any action. **NOTE:** If federal adjustments are based upon the lack of substantiation, you should give the taxpayer an opportunity to submit substantiation before closing the examination.

RAR on Years not under Examination

- **Federal Audit in Progress** - Forward the federal information to the RAR Unit in Central Office (see the mailstops listed below). Secure a copy of the IRS request for information, and a federal waiver if applicable.
- **Federal Audit Complete** - Get a copy of the RAR and forward it to the RAR Unit in Central Office (see the mailstops listed below).
- **Federal Audit Protest** - Get a copy of the RAR and forward it to the RAR Unit in Central Office (see the mailstops listed below).

Upon receipt of an RAR, you should write across the top of the RAR in red, "Voluntary" the date received, and your initials. Forward the RAR to:

PIT

RAR Unit - Pending Federal
Voluntary Team
Mailstop: D-740

Pending Federal (PF). The GTA RAR Unit keeps a file for audit cases where a protest or written correspondence is received by taxpayers in response to a Notice of Proposed Assessment indicating the case is still open with the IRS

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because of ongoing litigation. The RAR unit will withhold finalizing a protested NPA or withhold collection activity until the IRS makes a final determination.

CORP

RAR - ADF Unit

General Corporation Revenue Agent Reports

Mailstop: D-741

Audit Determination File (ADF) The GTA RAR Unit keeps a file for audit cases where Taxpayers inform us that the IRS is conducting an audit at the same time we began our state audit. Files held without payments are called ADF files. When the taxpayer anticipates owing additional tax and has made a pre-payment, we call the cases NPay cases. We hold these payments in suspense and hold all cases until IRS makes a final determination.

Check “*RAR Pend - FSSAS*” on the *Audit Report - Form FTB 6430* when routing. For additional routing instructions, see GTAM 13700, *Routing the Physical & Electronic Files*.

NOTE: When any written notification is received within six months of a final federal determination dated before January 1, 2000, the statute of limitations for voluntary Revenue Agent Reports is two years from the date of notification. For final federal determinations dated on or after January 1, 2000, the notification must be “sufficiently detailed” to allow computation of the resulting California change before the statute of limitations starts. Once the required documentation has been received, within the six-month period for reporting, the statute of limitations is two years. Under both old and new law if notification is received after the expiration of the six-month period for reporting, the statute of limitations is four years from the date of notification.

It is important that these cases receive special handling due to the shorter statute.

If the RAR Unit receives an RAR and finds that the case is assigned to you, they contact you before taking any action.

If you have any questions, please contact the RAR Unit [PIT cases * * * * * and corporation cases * * * * *]. You must issue any assessment based on the federal change within the appropriate time frames (see GTAM 10000, *Statute of Limitations*, for additional information).

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20701 GUIDELINES FOR WHEN TO FOLLOW A FEDERAL DETERMINATION

FTB AND IRS AUDIT IN PROGRESS - PRE NPA

If upon completing your audit, you learn an IRS audit is in progress, complete your audit. Inform the taxpayer of the statute of limitations for notifying us of the final federal determination. See GTAM 10000.

If during your audit, a federal audit is in progress, being appealed, [Cases protested to the IRS Appeals Office. Treas. Reg. 601.103(c)(1)] or petitioned [Cases petitioned to the U.S. Tax Court. Treas. Reg. 601.103(c)(2)] for the same tax year:

1. Obtain a copy of the IRS information that substantiates the federal status and a federal waiver, if applicable.
2. Contact the Federal and State Special Audit Section [This section's RAR unit is responsible for handling the Revenue Agent Reports for the General Tax Audit Program Bureau.] Revenue Agent Report Unit to determine the status of the federal activity and update PASS with comments.
3. Check all available resources before requesting reasonable and relevant information from the taxpayer or requesting the IRS audit file.
4. Verify the statute of limitations. See GTAM 10000.

To determine whether to follow the federal determination see CR&TC section 20702.

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20702 FEDERAL ADJUSTMENTS WITH A STATE IMPACT TO DIFFERENT TAX YEARS

SEE MAPM 12065

FTB AND FEDERAL AUDIT COMPLETED - POST NPA

GTAM 20703	Same Issues
GTAM 20704	Different Issues
GTAM 20705	Both Same and Different Issues

If a taxpayer protests our Notice of Proposed Assessment based on a Revenue Agent Report because the federal determination is not final, do the following:

1. Obtain a copy of the IRS information that substantiates the federal status and a federal waiver, if applicable.
2. Notify the taxpayer that we will transfer the case to the Pending Federal Unit and they will contact the taxpayer.
3. Complete the Audit Report, FTB Form 6430.
4. Transfer PASS case to:
 - a. PIT - 348 PIT RAR PF/ADF Group Worklist.
 - b. Corp - 389 Corp RAR New Arrivals
5. Route the case to:
 - a. PIT RAR Unit: 348 attn: Pending Federal MS D-745
 - b. Corp. RAR Unit: 348 attn: Pending Federal MS D-737.

If a taxpayer protests our Notice of Proposed Assessment based on a Revenue Agent Report because we previously audited the tax year and issued a no-change letter, claim allowed/denied letter, or Notice of Proposed Assessment:

1. Contact the taxpayer to get the details of the issues in writing and
2. Give taxpayers an opportunity to provide more information.

To determine whether to follow the federal determination, see GTAM 20706.

Reviewed: April 2003

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20702.1 Pre NPA Guidelines For When To Follow Federal

IF	AND	THEN
FTB AND IRS AUDIT ARE IN PROGRESS	ISSUES ARE:	
	SAME	See GTAM 20703
	DIFFERENT	Follow FTB GTAM 20704
	SAME & DIFFERENT	Follow IRS on same issues and complete state audit of different issues GTAM 20705

Reviewed: April 2003

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20703 Same Issues

If we are auditing the same issues as the IRS or the taxpayer requests that we suspend the examination until the federal audit is complete:

1. Notify the taxpayer we will route the case to the RAR Unit.
2. Inform the taxpayer of the statute of limitations for notifying us after a federal determination
3. Inform the taxpayer that the RAR will contact them about the federal audit's progress.
4. (CR&TC section 18622) and the statute of limitations when a federal audit is involved (CR&TC section 19059 and 19060).
5. Transfer PASS case to:
 - a. PIT - 348 PIT RAR PF/ADF Group Worklist.
 - b. Corp - 389 Corp RAR New Arrivals
6. Route the case(s) to:
 - a. PIT RAR Unit: 348 attn: Audit Determination File MS D-745
 - b. Corp. RAR Unit: 348 attn: Audit Determination File MS D-737.

Reviewed: April 2003

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20704 Different Issues

If we are auditing different issues from the IRS, continue the audit of the different issues.

When the audit is complete, transfer PASS case to:

- PIT - 348 PIT RAR PF/ADF Group Worklist.

Corp - 348 Corp RAR New Arrivals

Note the situation in the audit file and forward the Revenue Agent Report, a copy of the tax return, and federal information to:

- PIT RAR Unit: 348 MS D-745 Central Office
- Corp. RAR Unit: 348 MS D -737 Central Office.

Reviewed: April 2003

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20705 Both Same and Different Issues

If we are auditing both same and different issues from the IRS:

1. Tell the taxpayer you will continue to audit issues that differ from the federal issues.
2. Tell the taxpayer we will conform to the federal determination for issues that are the same for both state and federal purposes when we receive notification that the federal audit is final
3. Explain to the taxpayer the statute of limitations for notifying us after a federal determination (CR&TC section 18622) and the statute of limitations when a federal audit is involved (CR&TC section 19059 and 19060).
4. Tell the Revenue Agent Report Unit about the Federal audit.
5. When you have completed the audit involving the different issues, issue the appropriate notices.
6. Transfer PASS case to:
 - a. PIT - 348 PIT RAR PF/ADF Group Worklist.
 - b. Corp - 348 Corp RAR New Arrivals
7. Route the cases to:
 - a. PIT RAR Unit: 348 attn: Audit Determination File MS D-745
 - b. Corp. RAR Unit: 348 attn: Audit Determination File MS D-737.

Reviewed: April 2003

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20706 Post NPA Guidelines For When To Follow Federal

GTAM 20707	Same Issues
GTAM 20708	Different Issues
GTAM 20709	Both Same and Different Issues
GTAM 20710	Case Status Procedures
GTAM 20711	Federal Amended Returns
GTAM 20720	Senate Finance Committee (SFC) Internal Revenue Service Special Task Force (ISTF) Review

IF	AND	THEN
FTB AND IRS AUDIT ARE COMPLETED	ISSUES ARE:	
	SAME	Depends on facts and circumstances See GTAM 20707
	DIFFERENT	Follow IRS (unless fed/state differences) See GTAM 20708
	SAME & DIFFERENT	See GTAM 20709

Reviewed: April 2003

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20707 Same Issues

If the Notice of Proposed Assessment issues are the same as the Revenue Agent Report, determine whether the information the IRS used was new or different from what we used during the audit. Based on the facts and circumstances of the case, choose either the federal determination or our determination. Based on your determination, follow the appropriate case status procedures (see GTAM 20710).

Reviewed: April 2003

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20708 Different Issues

If the Notice of Proposed Assessment issues are different:

- Ask the taxpayer for more information.
- Consider whether the Notice of Proposed Assessment based on the Revenue Agent Report is correct as issued.
- When you have completed the audit, follow the appropriate case status procedures (see GTAM 20710).

Reviewed: April 2003

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20709 Both Same and Different Issues

If the Notice of Proposed Assessment includes issues that are both the same and different from the federal determination, follow the guidelines under CR&TC section 20707 (same issues) and CR&TC section 20708 (different issues).

Reviewed: April 2003

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20710 Case Status Procedures

GTAM 16100 Correspondence received

GTAM 16210 Untimely protest

GTAM 16220 Paid protest

GTAM 16240 Protest

GTAM 16300 Claim for refund

Upon completing one of the above actions, attach the Revenue Agent Report to the file and include a note to Audit Business Support to forward the complete file when all transactions have been completed to:

- PIT RAR Unit: 348, MS D-739 Central Office
- Corp. RAR Unit: 348, MS D - 739 Central Office

Reviewed: April 2003

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20711 Federal Amended Returns

If you receive a federal amended return before completing your audit, observe the following procedures:

- If a federal examination of the amended return is pending or incomplete, contact the Federal/State Examination Unit to verify the examination. If the amended issues are the same as the state audit issues, advise the taxpayer to file amended returns with us. We will process the state amended returns when the taxpayer tells us about the final IRS action on the federal amended returns (see GTAM 16370, *Protective Claims*, for additional information).

If the amended issues are *not* the same as the state audit issues, you should request a copy of the Notice of Refund, RAR, etc., from the Federal/State Examination Unit, once the final action is taken on the federal amended returns. Consider the amended return adjustments at audit, to the extent applicable for California purposes.

- If a federal examination of the amended return is complete, you should seek proof of the examination (Notice of Refund, RAR, etc.), and consider the amended return adjustments at audit, to the extent that they apply to California purposes.
- If there has been no federal examination of the amended return, and there is no sign that a federal examination is pending, address the issues in the same way as any other position a taxpayer might raise at audit. That the IRS issued a refund without examination does not control a state-issue audit. Depending upon the adjustment, you may need to audit the issues raised on the amended returns unless the federal amended return treatment is clearly appropriate for California purposes.

Reviewed: April 2003

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20720 Senate Finance Committee (SFC) Internal Revenue Service Special Task Force (ISTF) Review

During an examination, taxpayers may tell us that the SFC or the ISTF is reviewing their case. The Commissioner of the Internal Revenue Service has established a special task force to resolve cases brought before the SFC. These cases involve taxpayers that have written letters to the SFC with unresolved issues with the IRS in at least one tax year.

The SFC reviews these letters and asks taxpayers to sign a waiver authorizing the committee to forward the cases to the ISTF in Washington D.C. for resolution. The ISTF assigns the cases, through the IRS Advocate's Office, to a Problem Resolution Officer in a District Office or a Service Center near the taxpayer's home.

Once assigned, the IRS will review these cases and actively seek to resolve all potential issues, including issues the taxpayer has not raised. At the end of the examination, the taxpayer receives a notice of tax change or a closing letter.

Cases scheduled for review by the ISTF will *not* show as reopened cases on the Individual Master File transcript. Consequently, statements by a taxpayer that a case is in review by ISTF *cannot* be verified with an IMF transcript.

The IRS has an internal control database that lists the cases under ISTF review. We can get information on specific cases by contacting the IRS. We have made arrangements to fax the *Request for Federal Tax Information* - Form FTB 6227 to the Fresno Service Center. The IRS will fax a response showing:

1. If the case has been referred by the SFC, and if so,
2. To whom it has been assigned.

NOTE: To verify IRS or SFC involvement, contact the Federal/State Examination Unit.

Reviewed: April 2003

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20800 DISASTER ACTION PLAN - AUDIT DIVISION

GTAM 20810	Introduction
GTAM 20820	Roles & Responsibilities
GTAM 20830	Audit Division Guidelines
GTAM 20840	Audit Division Disaster Action Team

Reviewed: November 2004

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20810 Introduction

This disaster plan should make the Audit Division's procedures and activities consistent with our procedures and activities. When a disaster occurs, we defer all Audit Division correspondence and notices two weeks, with the exceptions noted below.

Reviewed: April 2003

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20820 Roles & Responsibilities

The Communication Services Bureau provides our staff with disaster information. They notify the Individual Tax Collection Bureau, division chiefs, and bureau directors. The Systems Management Section of the Individual Tax Collection Bureau identifies each disaster area's ZIP code, and notifies us so that we can employ disaster plans. The Audit Division Disaster Action Team executes disaster plans for its area. It is also notified when ZIP code areas are *removed* from the disaster area list.

Reviewed: April 2003

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20830 Audit Division Guidelines

The Audit Division will defer mailing all audit letters and notices to taxpayers in affected disaster areas for two weeks. Exceptions are:

- Assessments that could be barred by the statute of limitations. You should process and type these assessments manually.
- Taxpayers we have contacted who have requested that we not defer their mail.

These exceptions must have appropriate Bureau Director approval before mailing.

After two weeks, you may contact taxpayers or representatives to determine if we may proceed mailing letters and notices.

In addition, we may continue corresponding with any taxpayer or representative who requests it, whether or not the taxpayer is in an affected disaster area.

Reviewed: April 2003

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20840 Audit Division Disaster Action Team

The Audit Division Disaster Action Team ensures that we employ the procedures for mailing audit letters and notices following a disaster. They also develop and revise the attached procedures.



GTA DESK AUDIT

Process	Procedure	Contact
Notices		
NPAs, NORs	Do not create or send notices to ZIP Code areas on the disaster list	User
Correspondence		
Audit Letters	Do not create or send letters to ZIP Code areas on the disaster list.	User



GTA FIELD AUDIT

Process	Procedure	Contact
Correspondence		
Audit Letters	Do not create or send letters to ZIP Code areas on the disaster list.	Auditor
Audits in Progress		
<i>Audits</i>	Suspend audits in ZIP Code areas on the disaster list, until contact with taxpayer or taxpayer representative indicates audits may continue.	Auditor



AUDIT BUSINESS SUPPORT

Process	Procedure	Contact
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Notices		
PAWS (NPAs, NORs)	User gets a ZIP Code flag on PAWS when issuing notices to areas designated as disaster areas. (NOTE: User can override the flag if necessary. Must attach a note to the batch authorizing release.)	N/A
	Released Notices: Audit Business Support personnel pulls all notices addressed to affected ZIP Code areas, based upon the current disaster list	Audit Business Support Manager
Correspondence		
ADCORR (T/C, HW)	User must check current disaster list before writing letter. There is no ZIP Code flag for ADCORR. User can mail letter with a note attached to the batch authorizing the release of the letter.	User
	Released Letter: Daily edit reviews for ZIP Codes in designated disaster areas. They return all letters pulled to their authors.	Audit Business Support Manager



FED STATE AND SPECIAL AUDIT SECTION (FSSAS)

Process	Procedure	Contact
Notices		
PAWS (NPAs, NORs)	User gets a ZIP Code flag on PAWS when issuing notices to areas designated as disaster areas. User can override the flag if necessary. Must attach a note to the batch authorizing release.	N/A
	Released Notices: Audit Business Support personnel pulls all notices addressed to affected ZIP Code areas, based upon the current disaster list.	Audit Business Support Manager
Automated Notices	The Program Team coordinates pulling all notices addressed to the affected ZIP Code areas from the Mail Room.	FSSAS Program Team Manager or

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		Lead
Correspondence		
ADCORR (T/C, HW)	User must check current disaster list before writing letter. There is no ZIP Code flag for ADCORR. User can mail letter but must attach note to the batch authorizing release of the letter.	User
	Released Letter: Daily edit reviews for ZIP Codes in designated disaster areas. They return all letters pulled to their authors.	Audit Business Support Manager
Automated Letters (HOH, STARS)	The Program Team coordinates pulling letters from the Mail Room.	FSSAS Program Team Manager or Lead
PC (Speed Messages)	The maker or Lead checks ZIP Codes on the disaster listing before mailing any PC generated letters	User or Lead



Procedure

Technical Resource Section

Process	Procedure	Contact
Notices		
NPA's, NORs	Do not create or send letters to ZIP Code areas on the disaster list.	Reviewer

Reviewed: April 2003

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